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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I appreciate the opportunity to appear before you today at the start of a new Congressional session. We will be facing critical decisions on economic policy in the weeks and months ahead. Toward the middle of next month I will be reporting to the appropriate committees on monetary policy in more detail, and this morning will confine my statement to more general considerations.

Over the past two years, we have faced up squarely to the necessity of reining in the inflation that had come to grip the economy over a long period of time. There are now clear signs of tangible and potentially sustainable progress toward that objective. But the economy is also caught up in recession, following several years of unsatisfactory performance. In a real sense, the nation is paying the costs of the distortions and imbalances in our economy created in large part by the years of inflationary experience.

In approaching these problems, and in considering monetary, fiscal, and other policies, it seems crucially important that we keep firmly in mind the lesson of the 1970's -- sustainable growth cannot be built on inflationary policies. More positively stated, the progress we are clearly beginning to see on the inflation front, carried forward, will help lay the base for recovery and much better economic performance over a long period of time.

As you know, the economy, after a burst of growth early in 1981, levelled off, and in recent months strong recessionary forces took hold. Real consumption expenditures have declined,

in part reflecting an increased savings rate. A sustained higher rate of savings would, of course, be healthy in a longer term perspective, and a number of policy measures have been adopted to strengthen savings incentives. But in the short run, declines in consumption have led to unwanted inventories, sharp reductions in production, and postponement of some capital spending.

These are elements of a classic recession pattern, and at this point, the decline in economic activity has been of proportions comparable to other post-World War II downturns. What is different and so distressing is that the recession has been superimposed on a pattern of sluggishness extending over some years; unemployment was high to begin with, and now, at 8.9 percent, stands very close to its postwar peak. Moreover, we have been left with a legacy of extraordinarily high interest rates and financial pressures, conditions fundamentally associated with the years of inflationary behavior and expectations.

The upward trend in unemployment in recent years and the early onset of a new recession reflect both the difficulty of living with inflation -- and of bringing it to an end. Unsatisfactory economic performance, well below our reasonable potential, has extended over a number of years. The origins can be traced back at least as far as the mid-1960's, when, as a nation, we failed to accept the budgetary consequences of spending for a war and vastly expanded social programs at the same time. Once fairly

started, the inflationary process assumed a momentum of its own, with only short interruptions in earlier recessions. At intervals, the massive oil shocks, and to a lesser extent worldwide crop shortages, ratcheted up the inflation rate, affected the real income of most workers, and led to the need for large adjustments in our industrial structure, depressing some traditional industries while spurring others.

Through this period, one aspect of our economic problem became increasingly obvious. Inflation came to be viewed as a permanent part of the economic landscape, and workers and businessmen, savers and investors, borrowers and lenders built expectations of continued inflation into their daily economic decisions. There have been profound effects on financial markets and interest rates, inhibiting growth and investment. Higher effective tax rates became a drag on the economy, and the interaction of inflation with the tax system tended to reduce business profitability and divert both business and personal planning away from productive effort and innovation into more speculative or purely financial areas. It's worth recalling the culmination of the process in late 1979 and early 1980 when concern about the inflation and budgetary outlook brought interest rates to sharply higher levels and incited a speculative outbreak in commodity and precious metals prices, even as prices of long-term securities fell sharply. There was broad recognition that inflation was eroding the foundations of our economy, and that strong action had to be taken to restore stability.

In the circumstances existing, that job fell largely to the Federal Reserve and monetary policy. As you know, we have been pursuing a policy of reducing the pace of monetary expansion over a period of time to rates consistent with price stability. But monetary restraint, however necessary, can be a blunt instrument. That is particularly true when prolonged experience with inflation builds in expectations that it will continue, when inflationary momentum is built into cost and pricing behavior, and when productivity improvements are low.

For all its difficulty, monetary restraint must be an essential part of any successful effort to damp inflation. Strong upward price pressures may arise from a variety of sources not directly related to monetary conditions -- the oil price shocks are a leading example. But those impulses will persist and spread only if they are accommodated by growth in money. And, as we have learned, we cannot really "accommodate" to inflation without damaging economic growth and productivity.

Now, we can see highly encouraging signs that the inflationary tide is turning -- we see it in the data, and less tangibly, in expectations. The improvement, to be sure, has been associated with highly unsatisfactory business conditions. Prices of commodities, in particular, are sensitive to depressed demand, there are incentives to reduce inventories, and the weakened financial position of many companies has led to extraordinary efforts to restrain wages and costs generally.

No successful program to restore price stability can rest on persistent high unemployment and depressed profitability, any more than we can build prosperity on inflation. The obvious challenge is to shape our policies in a way that can permit and encourage recovery to proceed while maintaining the progress we are seeing toward greater price stability. Some of the groundwork has already been laid, or is in process. Price expectations have calmed, and there is some evidence that the underlying trend of costs is slowing.

Our current inflation did not originate as a "wage-push" phenomenon. But in an economy like ours, with wages and salaries accounting for two-thirds of all costs, sustaining that progress will need to be reflected in moderation in the growth in nominal wages. The general indices of worker compensation still show relatively little improvement, and prices of many services with a high labor content continue to show high rates of increase. But we are all aware of recent negotiations completed or in progress that seem to point toward significant moderation.

In many of these instances, to be sure, the changes reflect the most intense competitive pressures, and the potential benefits in terms of retaining jobs is clear. Major tests of the changing climate still lie ahead; 1982 is a particularly important bargaining year. It seems to me crucially important, not least for the workers directly involved and for those now unemployed, that this emerging pattern of greater moderation be extended. The end result of moderating nominal wages should be higher real wages for workers generally, for it can speed and sustain the process of recovery.

The prospect for greater price stability, at least in the near term, is reinforced by the outlook for stability in petroleum prices and ample crops. And looking further ahead, partly as a result of the more favorable tax climate, we should be able to achieve renewed and sustained growth in productivity as the economy grows.

Obviously, it is far too soon to claim victory in the fight on inflation. To make that prospect a reality, properly restrained and cautious monetary policy will continue to be required. And at the same time, we need to combine that anti-inflation effort with policies that will encourage and sustain the recovery process. The linkage lies in considerable part in encouraging favorable developments in financial markets and interest rates, and there are critical implications for the mix of governmental policies. An inadequate balance in policies can add to financial stress, with severe consequences for vulnerable credit-dependent sectors of the economy -- consequences most dramatically reflected in homebuilding and the problems of many small businessmen and farmers. Moreover, our need to improve and modernize our plant and equipment is evident. That need lay behind many of the tax changes enacted last year; but overburdening monetary policy in dealing with inflation, with consequences for financial pressures in the marketplace, can work against that very objective.

This year we will have a very large Federal deficit. To the extent that deficit is a passive reflection of recession --

which in turn reduces other credit demands -- even that deficit may be manageable without, in itself, standing in the way of a more favorable financing climate. The large Federal contribution to the income stream -- including the second stage of the tax cut at mid-year -- should help buoy economic activity. But during a period of recovery, deficits approaching the current magnitude would have quite another implication; in an environment of limited monetary expansion and rising private demands for credit, they would threaten prolonged strain and congestion in financial markets, with strongly adverse consequences for other borrowers. And those consequences are not merely a hypothetical possibility for the future. It is that concern that preoccupies the thinking of many potential investors in the market today, making them reluctant to commit funds for any long period of time, fearful that interest rates may not decline or could even rise.

You and I may think those concerns overdone, particularly in the light of the extraordinarily high level of rates today in relation to the prospects for inflation. But the lesson for policy seems to me unambiguous. Fiscal action needs to be directed toward the progressive and substantial reduction of the deficit as recovery proceeds.

We know there is a deep-seated public instinct associating large deficits with inflation, and a great deal of history pointing in that direction. We could also engage in abstract debate about whether budgetary deficits are necessarily inherently inflationary, and the point would be advanced that, given sufficiently severe

monetary policy, they might not be. But that would imply far higher interest rates, lower investment, and poorer economic performance generally. Paradoxical as it may seem, action by the Administration and the Congress to bring spending and our revenue potential into closer balance -- and ultimately into balance and surplus -- as the economy expands can be a major element, through its implications for credit markets, in promoting recovery and nurturing it. Credibility in the budget, through its effects on expectations and behavior, could only work toward lower interest rates and speeding the disinflationary process.

In essence, the burden of my comments is that the need for disciplined financial policies to carry through the anti-inflation effort is not lessened by the current recession. It's not just a matter of the longer-run -- to back away from the commitment to deal with inflation would be a disturbing matter for financial markets today, complicating the prospects for early recovery.

Interest rates fell appreciably last fall, and most have remained substantially below earlier peaks. But in both real and nominal terms, they remain extraordinarily high. The fact is markets remain sensitive, disturbed, and uncertain despite the encouraging trend toward less inflation. We cannot wish these doubts and skepticism about the future away; we can act to dispel them by our actions.

That, of course, has important implications for monetary policy. As I indicated at the outset, I will deal more specifically with our intentions with respect to monetary growth after the Federal Open Market Committee, in the normal course, meets next week to adopt guidelines for the coming year. The basic thrust of policy will remain one of encouraging continued progress on the inflation front. With such progress, there should be adequate financial resources to support renewed economic growth.

Present economic conditions are those of pain and hardship for many. In working to relieve them, let us not forget the basic circumstances that brought on the difficulty. Let us take heart from the signs of progress in turning the corner toward greater price stability. We can build on that progress, and, in doing so, restore the confidence and financial conditions so critical to recovery.

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